

STRATEGY 5: DETERMINING AND NEGOTIATING FAIR MARKET VALUE

Water rights acquisitions to restore instream flows, either through leases, purchases, dry-year options or other transactions involve the creation of new, untested markets. Although these new approaches are developing rapidly in some areas of the state, there are legal, physical and economic limits to water markets to increase stream flows. It is critical for Ecology to become more sophisticated and knowledgeable about how markets function efficiently. The public needs to be confident that their investment is getting the best “bang for the buck” and that both buyers and sellers benefit from the acquisitions.

I. Understanding the “water market”

Washington water markets are typically comprised of few buyers and relatively few sellers. Water markets face enormous uncertainty and potential high transaction costs. To overcome these limitations, measures must be undertaken to help reduce costs to both buyers and sellers. These include:

- Increasing certainty and acceptance regarding the Washington Water Acquisition Program.
- Examining all water rights involved in water acquisition transactions to assure acquired water can be placed into the state trust water program and used to enhance stream flows.
- Providing information about a particular water right, including its legal characteristics and whether it can be protected.
- Creating efficient legal and administrative mechanisms for processing transactions.
- Negotiating the right type and length of transaction contemplated.

II. Determining the price

Determining and negotiating a fair market value for water rights is essential to ensure the best value for fish, stream flows and public benefit. The price of a water right will be determined using either outside water appraisals or applying acceptable valuation methods (see below for common valuation methods).

Valuation methods will be used to establish an initial offer price, set negotiation time and inform current and potential sellers and buyers of the market condition. Water valuation will establish the value of the water in its current and potential future uses and a range of values will be generated that allow a well-informed buyer to select an initial offer price that will be closer to the ultimate sales price.

Water valuation reports or appraisals can play an important part in negotiations to offset unrealistic price expectations. Appraisal reports provide a way for prospective buyers and sellers to objectively compile and analyze information that may influence both price and sales terms. In addition, using water evaluation methods to estimate the value of the water rights in its current use prior to engaging in negotiations can reduce the risk of paying more for water than necessary and can help diffuse seller price expectations. A valuation report or appraisal can

combine valuation approaches to set a range of the value of the water rights to start final negotiation of the purchase price.

Ecology will use as much as possible the following approach in determining and negotiating fair market value for water rights proposed for acquisition with Ecology-administered funds:

- **A market appraisal using two or three of valuation approaches** should be obtained prior to starting negotiation on the value of water rights purchases and long-term leases. These water rights appraisals will generally be used for transactions greater than \$50,000.
- **For short-term leases, seasonal leases, and purchases or long-term leases under \$50,000**, the income capitalization approach to determine the value of the water right should be used.

All transactions will have the water right examined thoroughly to assure the purchased water can be placed into the state trust water right program and can be used to enhance stream flows. All transactions funded by state monies will be covered by contract. A template contract for buying or leasing water rights is available in **Appendix IV**.

III. Common water valuation methods

1. Sales comparison method

This method involves comparing the subject water right with similar water rights that have been sold or leased. Sufficient sales data are required to make accurate comparisons. If necessary, the sales information from other similar basins can be supplemented to develop a more comprehensive analysis. Thorough knowledge of the terms and conditions of the sales is required to ensure that the values are comparable to the water rights proposed to be purchased.

2. Land price differential method

Land and water are commonly sold together — water rights are rarely separated from the land. Therefore, market sales identifying the value of the water in alternative uses are limited. The land price differential is a useful addition to the sales comparison approach in regions where buying and selling of water rights separately is relatively uncommon. The approach reveals the implicit price of water by comparing sales of land with and without water rights. The difference in value between irrigated and non-irrigated land represents the incremental value attributable to the water rights.

3. Income capitalization method

The income capitalization method can be used to estimate the agricultural value of water in its current use. It involves determining the contribution of irrigation water to net revenue from agriculture production. The approach is well-suited for measuring the foregone agriculture revenues resulting from production losses due to reduction in available water supply. Physical characteristics of the land, irrigation application, delivery system, and crop yields under irrigated and non-irrigated conditions are incorporated into the analysis to reflect on-farm conditions as accurately as possible. Available information about physical factors such as irrigation efficiency factors, crop requirements, return flows, and variation in local climate conditions are used to determine the irrigation application requirements for a specific area.

4. Replacement cost method

This method involves examining the potential supply side of the market. Constraints on existing water resources in a basin as well as current uses of water within a market area have important value impacts that must be considered. A water right's value in a particular market is limited by the costs of obtaining water from an alternative source. In a well-functioning market, the price of a surface water right will not exceed the cost of drilling and operating a well – assuming that ground water is available and of comparable quality. In basins closed to new surface and groundwater development, characterization of other permitted and certificated water uses will help identify where potential new users in the basin might obtain supplies.